

Decision 05-01-057 January 27, 2005

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish A Framework for Network Architecture Development of Dominant Carrier Networks.

Rulemaking 93-04-003
(Filed April 7, 1993)

Investigation on the Commission's Own Motion into Open Access and Network Architecture Development of Dominant Carrier Networks.

Investigation 93-04-002
(Filed April 7, 1993)
(Verizon UNE Phase)

**OPINION MODIFYING DECISION 03-03-033
TO ADJUST INTERIM UNBUNDLED
NETWORK ELEMENTS RATES**

I. Summary

In Decision (D.) 03-03-033, the Commission adopted interim rates for a subset of unbundled network elements (UNEs) Verizon California Inc. (Verizon) sells to competitive local exchange carriers. In adopting interim UNE rates, the Commission relied on UNE rates recently adopted for Verizon in New Jersey, and then adjusted these rates based on the Federal Communications Commission's (FCC) Synthesis Model to compare relative costs between Verizon's operations in California and New Jersey. (D.03-03-033, p. 33.) This decision grants a petition for modification of D.03-03-033 and adjusts the interim rates to reflect recent increases in Verizon New Jersey UNE rates. In addition, this decision removes the 22% shared and common cost, or "overhead," markup

initially added to the interim rates and relies instead on the overhead markup incorporated into New Jersey rates. The new interim rates are set forth in Appendix A, and the changes include a 2.3% decrease in Verizon's interim 2-wire loop rates to \$10.32 and \$21.87 in Zones 1 and 2, respectively. Verizon's interim 4-wire loop rates decrease 1.9% to \$21.31 and \$45.17 in Zones 1 and 2, respectively. Verizon's interim port rate is increased 28.3% to \$2.72.

II. Verizon's Petition for Modification

On May 21, 2004, Verizon filed a petition requesting modification of D.03-03-033 because the New Jersey Board of Public Utilities (the "Board") had recently modified its UNE rates.¹ Verizon states in its petition that given the Commission's reliance on New Jersey rates, the Commission must now increase the interim rates to reflect adjustments made by the New Jersey Board.

In D.03-03-033, the Commission found it was reasonable to rely on UNE rates from New Jersey rates because "these are among the most recent forward-looking, TELRIC-based UNE rates" for Verizon. In its petition, Verizon alleges that because the New Jersey Board has modified its UNE rates, interim rates in California are based on outdated New Jersey UNE rates, which are no longer reasonable and must be adjusted.

Specifically, the New Jersey Board made upward adjustments to its UNE rates after finding the cost of capital it had previously adopted required modification to consider future competition and the risk of operating in a

¹ See *In the Matter of the Board's Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.*, Decision and Order, Docket No. TO00060356, (N.J.B.P.U., May 7, 2004) ("New Jersey Order"), which is included in Verizon's Petition, 5/21/04, Exhibit A to the Declaration of Michele Meny.

competitive market. The Board increased the cost of capital used as an input in its cost studies from 8.82% to 9.88% and it modified switching port and usage

rates to correct cost modeling and allocation errors.² The Board's decision adopting new UNE rates for Verizon New Jersey went into effect on May 14, 2004. Verizon contends these New Jersey UNE rate adjustments are a material change in circumstances that warrant modification of D.03-03-033. Therefore, the Commission must revise its interim UNE rates upwards by the same margin adopted in New Jersey.

Verizon includes in its petition a recalculation of its interim UNE rates based on the newly adopted New Jersey rates. In D.03-03-033, the Commission adjusted New Jersey UNE rates to reflect a Synthesis Model comparison of UNE costs in California and New Jersey. Verizon contends it uses the same methodology applied in D.03-03-033 with the newly adopted New Jersey rates. As a result, Verizon requests the Commission increase the 2-wire interim loop rate by \$0.89 in Zone 1 and \$1.89 in Zone 2; the 4-wire interim loop rate by \$1.90 in Zone 1 and \$4.06 in Zone 2; the interim port rate by \$0.90; the interim end office switching usage rate by \$0.000239; and the interim tandem switching rate by \$0.000151.

Commission Rule 47(d) specifies that petitions for modification shall be filed within one year of the underlying order. Verizon contends that although its petition is filed more than one year following adoption of D.03-03-033 on March 13, 2003, its current petition is justified because the New Jersey Board did not issue its decision with updated UNE prices until May 7, 2004. Therefore, Verizon could not have filed this petition prior to the release of the Board's order.

² Verizon Petition, 5/21/04, pp. 3-4; *see also* New Jersey Order, pp. 21 and 35.

III. Comments on Petition

Comments on Verizon's petition were filed jointly by AT&T Communications of California, Inc. (AT&T) and MCI Corp. (MCI), and jointly by a group of small competitive local exchange carriers (CLCs), namely Anew Telecommunications Corp d/b/a Call America, DMR Communications, Navigator Telecommunications LLC; and Tri-M Communications d/b/a TMC Communications (collectively, the "small CLCs").

AT&T/MCI contend that Verizon's petition should be denied for several reasons. First, the petition fails to establish new material facts requiring modification of D.03-03-033 because the Commission did not rely on New Jersey rates to the extent alleged by Verizon. Rather, AT&T/MCI explain that the Commission compared Synthesis Model results for California and New Jersey and modified the New Jersey rates upwards wherever modeling results indicated higher costs in California. Therefore, they argue that although New Jersey has changed a few modeling inputs, this does not mean the Commission is required to modify its interim rates.

Second, AT&T/MCI maintain it is not necessary for the Commission to stop its efforts to set permanent UNE rates for Verizon by opening a proceeding to modify interim rates when Verizon's interim rates are subject to true-up and it is not harmed by the current level of interim rates.

Third, AT&T/MCI argue the Commission cannot accept Verizon's unverified calculations that convert New Jersey rates into new interim rates for Verizon California. According to AT&T/MCI, recent New Jersey UNE rate changes are interim and still under review for accuracy. Finally, they suggest that if there is any fine-tuning of interim UNE rates, it should involve lowering the 22% shared and common cost markup factor incorporated into the interim

rates to the 10% level adopted in New Jersey, particularly since Verizon itself now proposes a common cost markup of approximately 9% in its most recent filing in the permanent phase of this proceeding.

The small CLCs oppose Verizon's petition for many of the same reasons, emphasizing Verizon's petition will unnecessarily delay the permanent UNE rate proceeding and disagreeing with Verizon's assertions that interim rates based on initial New Jersey rates are no longer valid. In addition, the small CLCs disagree with Verizon's claims that it is harmed by the current interim rates, particularly given Verizon's statements in other forums that it will maintain UNE rates at current levels. Specifically, the small CLCs cite statements by Verizon to the Commission that it would not immediately raise rates on UNEs as a result of the FCC's TRO and that it would maintain current UNE rates for mass market UNE-Platform customers for five months. (Small CLC response, 6/21/04, p. 7.)

IV. Discussion

We find Verizon's petition for modification of D.03-03-033 reasonable and we will grant it. The interim rates adopted in D.03-03-033 used the Verizon New Jersey UNE rates as a starting point for an analysis involving the FCC's Synthesis Model. Now that the New Jersey Board has found it reasonable to adjust these rates, both to modify the cost of capital and to correct a cost allocation error involving switching, it is logical that interim rates in California based on the original New Jersey rates should be adjusted as well, as long as the adjustment is not unduly burdensome to calculate or implement.

The protests of AT&T/MCI and the small CLCs are not persuasive, except on the issue of the shared and common cost markup. First, AT&T/MCI claim the Commission did not rely on New Jersey UNE rates to the extent suggested by Verizon. While it is true the Commission performed its own analysis and did not

simply apply New Jersey rates to California, the New Jersey UNE rates were the starting point for the Synthesis Model analysis used in D.03-03-033 to set interim rates. Now that the starting point has been corrected and modified, and given that it is not an onerous process to translate the updated New Jersey rates into our own interim rates, we find it reasonable to make the adjustments suggested by Verizon.

Second, the protesting parties argue that adjusting interim rates will take valuable time and resources away from the efforts to set permanent rates for Verizon. We do not agree with this assertion. Verizon has provided the calculations to adjust its interim rates based on the newly adopted New Jersey rates. The staff of our Telecommunications Division verified these calculations and the rate adjustments are not complex. There is no need for a protracted proceeding to debate how to make interim rate adjustments. The adjusted interim UNE rates are found in Appendices A, B and C to this order, which replace the appendices in D.03-03-033.

Third, AT&T/MCI claim the New Jersey rates are still interim. While it is true that the May 21, 2004 order by the New Jersey Board required a compliance filing, that has now occurred and the rates are final.³ The adjusted New Jersey rates are now in effect and this Commission can rely on them to the same extent it relied on the earlier New Jersey rates.

³ On September 28, 2004, Verizon filed a motion requesting official notice of the September 22, 2004 decision of the New Jersey Board rejecting petitions for reconsideration of its May 7, 2004 UNE rate decision. (*See In the Matter of the Board's Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.*, Decision and Order on Motions for Reconsideration and Request for Limited Reopening and Motions to Strike, Docket No. TO00060356 (N.J.B.P.U., Sept. 22, 2004).) Verizon's motion is unopposed and we will grant it.

Fourth, the protesting parties claim there is no need to adjust interim rates since they are already subject to adjustment, or “true-up,” once final rates are adopted. Along the same lines, the protesting parties claim a change in interim rates will create unnecessary complexity in the true-up process. We agree with Verizon that the mere existence of a true-up mechanism at a later date should not prevent adjustment of interim rates based on the best information available, and modifying interim rates will send appropriate market signals because the new rates are based on the most current Verizon New Jersey rates. Finally, we disagree that the true-up will be complicated by this adjustment. When permanent rates are set, the true-up will reflect (1) the difference between the original interim rates and permanent rates for the period the original interim rates were in effect, and (2) the difference between the revised interim rates and permanent rates for the period that revised interim rates are in effect. Verizon's explanation is straightforward and we agree this is how the true-up should be calculated once final rates are set.

With regard to the shared and common cost markup, we agree with AT&T/MCI that we should not ignore the great disparity between the 22% used in the interim rates, the 9% now proposed by Verizon, and the 10% incorporated into Verizon's New Jersey rates. Verizon says these percentages are all based on different methodologies and cannot be compared. While that may be true, we find it more reasonable to use the more recent percentage incorporated into Verizon New Jersey rates, even if it is based on a new methodology, rather than the 22% we first adopted in 1997 based on a methodology that Verizon no longer uses. Therefore, we remove the markup adjustment initially adopted in D.03-03-033 when calculating the new interim rates. Because this change is made in response to comments on the draft decision, it is explained in greater detail in

the section below. We recognize that while this change to the overhead markup negates the effect of the New Jersey rate modifications for Verizon's UNE loop rates, interim UNE switching rates are still increased over the rates originally adopted in D.03-03-033.

V. Comments on Draft Decision

The draft decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties in accordance with Section 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. Comments were filed by AT&T/MCI and reply comments were filed by Verizon and XO California, Inc. (XO).

AT&T/MCI recommend the Commission deny Verizon's petition to modify interim rates for several reasons. First, they claim the draft decision is arbitrary and capricious because it only considers information regarding New Jersey rate changes, but ignores evidence of possible cost decreases, particularly to the shared and common cost markup. Specifically, AT&T/MCI note that the 22% shared and common cost markup included in the current interim prices is more than twice the 9.07% markup Verizon has proposed in the permanent phase of this proceeding. Furthermore, AT&T/MCI claim that 2004 Synthesis Model results indicate sharp cost declines in California that the Commission should consider when adjusting interim rates. Therefore, AT&T/MCI urge the Commission to consider this key evidence if it grants Verizon's petition.

Second, they claim the draft decision departs from Commission precedent regarding the cost of capital and the proper basis for interim prices without adequate explanation. For example, the Commission explicitly rejected the idea

of a risk adder to the cost of capital in the SBC California UNE proceeding,⁴ but modifies Verizon's rates in the draft decision based on the newest Verizon New Jersey cost of capital which now includes a risk adder. In sum, AT&T/MCI request a denial of Verizon's petition to modify, or in the alternative, consideration of evidence of cost decreases if any adjustments are made to interim UNE rates.

XO agrees with AT&T/MCI that the draft decision legally errs in ignoring information of cost decreases, particularly Verizon's newest 9% markup proposal in the permanent phase of this proceeding.⁵

In response to AT&T/MCI's comments, Verizon maintains it is appropriate to adjust the interim UNE rates to reflect New Jersey rate changes, but inappropriate to consider other evidence of alleged cost declines, as AT&T/MCI suggest. Regarding the shared and common cost markup, Verizon claims it is improper to compare the 22% used in the interim rates with the 9% Verizon proposes in its latest study because these markup percentages were calculated with different methodologies. According to Verizon, shared and common costs that were once combined in the 22% markup are now broken out into different factors and loadings. Thus, Verizon does not concede that shared

⁴ See D.04-09-063, *mimeo.* at p. 164. SBC California is the name used by Pacific Bell Telephone Company to do business in California.

⁵ Verizon objects that XO's comments on the draft decision which echo support for AT&T/MCI's comments, do not strictly adhere to Rule 77.5 of the Commission's Rules of Practice and Procedure requiring that reply comments "be limited to identifying misrepresentations of law, fact, or the condition of the record contained in the comments of other parties." Verizon is correct that Rule 77.5 does not invite "me-too" comments. Therefore, although we note XO echoes the views of AT&T/MCI, we will generally disregard XO's comments.

and common costs in its latest cost filings are limited to 9%. Verizon also maintains that AT&T/MCI's reference to 2004 Synthesis Model results is untimely, improper, and inappropriately diverges from the analysis originally used by the Commission in D.03-03-033. Furthermore, Verizon defends the draft decision as consistent with Commission precedent because D.03-03-033 adopted the New Jersey UNE rates as a starting point without independently reviewing the individual inputs, such as the cost of capital, that comprise the New Jersey rates.

The comments of AT&T/MCI are generally unconvincing, except with regard to the shared and common cost markup. On all other points, we agree with Verizon that rate changes to reflect adjustments to Verizon New Jersey rates are appropriate, and Commission precedent does not prevent this adjustment. It would be inappropriate to review individual inputs to the New Jersey rates, such as cost of capital, when we did not take this approach in D.03-03-033. We also agree it is untimely for AT&T/MCI to suggest that we consider 2004 Synthesis Model results, since the parties did not raise this issue in response to Verizon's petition to modify.

With regard to the shared and common cost markup, however, we acknowledge that the draft decision did mistakenly overlook AT&T/MCI's original comments to consider adjusting the 22% shared and common cost markup on the basis that Verizon itself is now proposing a 9% markup. When interim rates were first adopted in March 2003, AT&T/MCI pressed for a lower markup at that time. The Commission rejected the request, citing the 22% markup as California-specific, unlikely to be reduced to a 10% level, and similar to the 21% markup adopted for SBC California. (D.03-03-033, pp. 46-47.) Now, Verizon proposes a 9% common cost markup for California and the Ninth Circuit

Court of Appeals has remanded the 21% SBC California markup back to the Commission.⁶ The Verizon New Jersey rates include an overhead markup of 10%, substantially below the 22% markup incorporated into Verizon's interim rates in California. In comments on the draft decision, AT&T/MCI claim it is legal error for the Commission to ignore their claims that much has changed since the Commission decided to add a 22% markup to interim rates.

Essentially, we now question the validity of using a 22% markup originally adopted in 1997, using pre-1997 data and analyses, when a more recent TELRIC study for Verizon operations in New Jersey indicates a 10% overhead rate is adequate. Given the admitted changes in methodologies in the last decade, it makes more sense to assume that New Jersey UNE rates incorporate a forward-looking common cost markup factor that can be relied on, and then adjusted based on Synthesis Model results as we did in D.03-03-033. Verizon contends that the 22% markup embedded in interim rates was calculated with an entirely different methodology than the 9% it now proposes, and it is improper to assume that shared and common costs are only 9% because Verizon now breaks out shared and common costs into new and different loading factors. If, as Verizon contends, current methodologies shift costs once considered shared and common into direct UNE charges, then our use of recently derived New Jersey rates and their embedded overhead markup as a starting point should adequately reflect all costs, both direct, shared and common. If Verizon's new methodologies assign more shared costs directly to UNEs, then our approach of adding a 22% shared and common cost markup based on an

⁶ *AT&T Communications of California, Inc. v. Pacific Bell Telephone Company*, 375 F.3d 894 (9th Cir. 2004.)

outdated methodology has the potential to double-count shared costs. In D.03-03-033, we did not consider it likely that a 22% markup in California could drop to as low as 10%. But given Verizon's newest proposal and its explanation that new methodologies assign more costs directly to UNEs, this rationale is no longer well supported. Therefore, we now reverse our earlier position and find that based on the overhead factors adopted in New Jersey and proposed by Verizon in California, it is more reasonable to use the New Jersey UNE rates, including their embedded markup factor, rather than combining 2004 New Jersey UNE costs with a 1997 California markup factor.

This approach is further supported given the recent Ninth Circuit remand of SBC California's 21% markup factor. Initially, we hesitated modifying the 22% markup factor, noting its similarity to the 21% adopted for SBC California. With the remand and the current uncertainty in the SBC California markup, we can no longer rely on this comparison.

In summary, we will modify the methodology we originally used in D.03-03-033 when calculating interim rates. Rather than removing the New Jersey 10% common cost markup and inserting our own 22% markup, we will simply use the New Jersey UNE rates without modifying their markup factor, and then apply our Synthesis Model adjustments as we did in D.03-03-033.

VI. AT&T's Petition for Modification

On December 10, 2004, AT&T/MCI filed a separate petition requesting modification of D.03-03-033. AT&T/MCI request that the Commission modify Verizon's UNE rates to reflect the updated shared and common cost markup proposed by Verizon in the permanent phase of this proceeding. AT&T/MCI's petition largely repeats the arguments from their comments on Verizon's petition

and the subject matter of the petition has been addressed through this order.

Therefore, AT&T/MCI's petition is denied as moot.

VII. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Dorothy J. Duda is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. In D.03-03-033, the Commission set interim rates for a subset of Verizon's UNEs, using UNE rates recently adopted for Verizon's operations in New Jersey as a starting point and adjusting these rates based on the FCC's Synthesis Model.

2. On May 7, 2004, the New Jersey Board adjusted UNE rates for Verizon New Jersey to modify the cost of capital and to correct a cost allocation error involving switching.

3. Verizon's petition was filed more than one year following D.03-03-033 because the New Jersey Board adjusted Verizon New Jersey UNE rates in May 2004.

4. Verizon proposes a 9% shared and common cost markup in the permanent phase of this proceeding, compared to a 10% markup adopted for Verizon New Jersey.

5. The 21% markup included in SBC California rates has been remanded to the Commission for further review.

Conclusions of Law

1. It is reasonable to adjust Verizon's interim UNE rates based on adjustments to New Jersey rates because the changes are not unduly burdensome to calculate or implement.

2. For interim ratesetting purposes, it is reasonable to rely on recent overhead calculations incorporated into Verizon New Jersey rates rather than the 22% markup originally adopted in 1997.

3. Verizon's petition for modification of D.03-03-033 should be granted.

4. The rates set forth in Appendices A, B, and C of this order should replace the rates in Appendices A, B, and C. of D.03-03-033.

O R D E R

IT IS ORDERED that:

1. The May 21, 2004 petition of Verizon California Inc. (Verizon) to modify Decision (D.) 03-03-033 is granted.

2. Appendices A, B, and C of this order should replace Appendices A, B, and C in D.03-03-033.

3. The petition for modification filed by AT&T Communications of California and MCI, Inc. on December 10, 2004 is denied as moot.

This order is effective today.

Dated January 27, 2005, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
DIAN M. GRUENEICH
Commissioners

I dissent.

/s/ SUSAN P. KENNEDY
Commissioner